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AGENDA ITEM 4

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Employer Rate Stabilization Policy – Second Reading

II. PROGRAM: Actuarial & Employer Services

III. RECOMMENDATION:

That the Committee recommends to the full CalPERS Board the adoption of an Employer Rate Stabilization Policy to include the following changes to help reduce volatility in employer contribution rates. These changes will become effective with the June 30, 2004 actuarial valuations which set employer contribution rates for fiscal 2005-06 for State and School plans and fiscal 2006-07 for public agency plans.

Adopt an Employer Rate Stabilization Policy (see Attachment 1) to:

(A) Change the Board's actuarial asset smoothing policy No. 95-05C as follows:
1. In the calculation of the actuarial value of assets, spread market value asset gains and losses over 15 years as opposed to the current 3 years; and
2. Change the corridor limits for the actuarial value of assets from 90%-110% of market value to 80%-120% of market value.

(B) Change the Board's amortization policy No. ACT-96-05E as follows:
1. Calculate the annual contribution amount with regard to gains and losses as a rolling 30 year amortization of all remaining unamortized gains or losses as opposed to the current 10% of such gains and losses; and
2. Eliminate (B) (6) from the existing policy which is obsolete language regarding the amortization of the State plans' unfunded liability.

(C) Adopt a new Board policy imposing a minimum employer contribution rate equal to the employer normal cost minus a 30 year amortization of surplus, if any.

IV. ANALYSIS:

Recap of First Reading (March 2005 Meeting)

At the March 2005 Benefit and Program Administration Committee meeting, the actuarial staff presented to the members of the Committee an extensive agenda item on the topic of rate stabilization. That agenda item included the results of all the analysis that had been performed by staff. In total, staff analyzed the impact of 34 methods that could be implemented to reduce fluctuation in contribution rate.

As mentioned in the March 2005 agenda item, the analysis of smoothing methods must simultaneously investigate the impact on the employer's contribution rates and the impact on the funded status of the plans at CalPERS.

The objectives of the analysis were to seek the smoothing method that "best" simultaneously:

- **Minimizes the impact on the funded status of the plans**
- **Minimizes the volatility in the employer's contribution**
- **Minimizes the average future employer contribution.**

An additional objective was to find a method that accomplishes the three objectives above and produces employer rates that comply with the generally accepted accounting standards as provided by Governmental Accounting Standards Board Statement No.27 (GASB 27).

In accordance with the objectives above, staff eliminated the methods that did not preserve funded status, or did not reduce employer rate volatility by at least 50% of that produced by the current methods, or did not comply with GASB statement 27. Staff also considered the impact of each method on the average employer contribution rate and eliminated all but one method.

The resulting recommended method consists of increasing the actuarial value of assets corridor from 90%-110% of market value to 80%-120% of market value, spreads market value asset gains and losses over 15 years, and amortizes all unamortized gains and losses over a rolling 30 year amortization.

In addition, staff is recommending, following direction from Committee members at the March 2005 meeting, a minimum employer contribution rate equal to the employer normal cost minus a 30 year amortization of any surplus. As mentioned at the last meeting, such a minimum rate would be in compliance with GASB Statement 27. It should be noted that even with this minimum contribution, employer rate for very well funded plans would still be zero.

Staff recommends adopting the Employer Rate Stabilization Policy, which would change the two existing Board policies described above and add the new policy, to help reduce the volatility in employer contribution rates and without having a materially adverse impact on the actuarial soundness of the System or harming the security of the benefits of members and beneficiaries.

Effective Date of Proposed Rate Stabilization Method

Staff recommends that the proposed rate stabilization method become effective with the June 30, 2004 actuarial valuations. These valuations set State and School employer contribution rates for fiscal year 2005-06 and public agency employer contribution rates for fiscal year 2006-07.

An advantage of implementing the proposed rate stabilization methods as of the June 30, 2004 actuarial valuations is that the actuarial value of assets is very close to market value on that date. The strong investment performance for 2003-2004 (16.7% return) will eliminate most unrecognized prior investment losses as of June 30, 2004. It should be noted that most plans will still have a small asset loss in their actuarial value of assets for fiscal 2003-2004 and that loss will be reflected in the June 30, 2004 valuation.

It should also be noted that some public agency employers have expressed interest in having the proposed method apply to the 2005-2006 fiscal year contributions rather than the 2006-2007 contributions. Staff does not recommend this for the following reasons:

- Extensive amount of work involved. Approximately 2000 valuations and reports as of June 30, 2003 would have to be redone.
- Current Board policy No. ACT-96-05E permits employers to request an extension of the amortization of any unfunded liability over a period of up to 30 year. This policy provides rate relief for employers that need it.
- On June 30, 2003 the actuarial value of assets was110% of market value. While this earlier implementation would produce lower contribution rates for fiscal year 2005-2006, the unrecognized investment losses would prevent employers from receiving any additional relief from short term investment performance and rates would continue to increase in the short term.

Implementation of Proposed Rate Stabilization Method

The change in the calculation of the actuarial value of assets (using 15 years rather than 3 to spread market gains and losses) will have only a minimal impact when first implemented on June 30, 2004 because there will be less than 2% unrecognized market losses remaining as of that date. So, there is very little difference between spreading that 2% loss over the current 3 years or the new method of 15 years.

On the other hand the change to a 30 year amortization period on all unrecognized losses will have a more significant impact on employer rates. In implementing this part of the new methodology, there is one issue that should be fully disclosed. That issue is that many employers have received one or more fresh starts over the past several years. Recall that a fresh start is when multiple amortization bases are combined into a single base. Therefore, for all plans that have received fresh starts, amortization bases established due to benefit improvement, or changes in actuarial methods or assumptions have been combined with gain and loss bases and staff cannot distinguish between the gains and losses that should be amortized over the rolling 30 year period and the portion of the fresh start base that should be amortized over different periods of time.

For most plans with an unfunded liability, the major portion of the unfunded liability is due to prior asset performance less than the actuarially assumed return. Therefore, CalPERS staff recommends that all fresh start bases be converted to a gain and loss base and amortized over the rolling 30 year period.

The following summarizes the implementation policy being recommended:

- All existing gain and loss bases should be amortized over the rolling 30 year period.
- All existing amortization bases for benefit improvements, assumption changes, method changes and initial unfunded liabilities for new agencies will continue to be amortized under their current period.
- All existing fresh start bases will be converted to gain and loss bases and amortized over a rolling 30 year period.

Preserving the Security of Benefits

The analysis performed by the actuarial staff demonstrated that the proposed method would not harm the benefit security of members. However, it is possible that the applicability of the new methods might jeopardize the security of benefits of members if a plan is currently poorly funded. If the chief actuary determines that this is the case for a specific plan, then the chief actuary continues to have the right under current Board policy (ACT-96-05E paragraph (B)(6)(a)(5)) to amortize the unfunded liability for that plan over a shorter period of time.

Implementation for Risk Pools and Pooled Plans

Beginning with the June 30, 2003 actuarial valuation, all public agency plans were mandated in a risk pool if the number of active members in the plan was at or below 100.

In order to preserve equity and ensure that employers with surplus did not pay for employers with an unfunded liability, a side fund was created for each plan at the time of joining a risk pool. That side fund represented the difference between the assets and liabilities at the time of joining a risk pool. These side funds were amortized over time and are expected to disappear once the amortization is completed.

Since side funds were created mainly to ensure equity at the time of creating risk pools, staff will apply the proposed rate stabilization method at the risk pool level only. The amortization of side funds for pooled plans will not be affected by the implementation of the proposed rate stabilization method. Side funds will continue to be amortized in accordance with the schedule established at the time of joining a risk pool.

Implementation of Minimum Employer Contribution Rate

Implementing a minimum rate equal to the employer normal cost less a 30 year amortization of any surplus will result in an increase in contribution rate for a number of employers. Staff went back to see what would have been the impact on employers had the minimum rate been implemented in the June 30, 2003 actuarial valuations. Since none of the State plans and the Schools pool had a surplus on June 30, 2003, the minimum rate has no immediate impact on them.

For public agencies, a total of 35 non-pooled plans still had a surplus in the June 30, 2003 actuarial valuation. The table below shows the impact of the minimum rate on the employer contribution rate had we implemented this minimum rate in the June 30, 2003 actuarial valuations which set the 2005-2006 employer contribution rate:

Estimated Impact of Minimum Employer Contribution Rate

Increase in Employer Rate	Number of Non-Pooled Plans
No Change	3 Plans
Increase of Less than 1% of Payroll	23 Plans
Increase Between 1% and 2% of Payroll	8 Plans
Increase Between 2% and 3% of Payroll	1 Plans

As mentioned earlier, the amortization schedule of the side funds will remain the same with the implementation of the proposed rate stabilization method. Therefore, for plans participating in one of the risk pools the minimum employer contribution rate will be applied at the risk pool level and not for individual employers.

For superfunded employers, the implementation of the minimum employer rate is not expected to have any impact. Since the minimum employer contribution rate will be equal to the employer normal cost minus a 30 year amortization of any surplus, we expect that for most superfunded plans the minimum rate will still result in an employer rate of zero. Staff went back to see what would have been the impact on superfunded plans had the minimum rate been implemented in the June 30, 2003 actuarial valuations. For all 50 superfunded plans the employer contribution rate for fiscal year 2005-2006 would have remained 0%.

V. STRATEGIC PLAN:

The proposed rate stabilization method supports Goal IV of the CalPERS' Strategic Plan. The Plan reads as follows:

Goal IV
Assure that sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize employer contributions.

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Attachments